

- In *Stoneridge*, the Supreme Court ruled that businesses may not be sued in private securities fraud lawsuits unless they themselves make deceptive statements or acts directly relied on by investors.
- The Court sought to shield parties in “the realm of ordinary business operations” who do not attempt to “affect securities markets” from the risks and costs associated with private shareholder litigation.
- The SEC and Justice Department may still proceed against businesses that participate in fraudulent schemes or otherwise “aid and abet” fraud.

***Stoneridge*: No Private Liability for Securities Fraud Absent Investor Reliance**

On January 15, 2007, in *Stoneridge Investment Partners v. Scientific-Atlanta*, a 5-3 ruling, the U.S. Supreme Court sharply limited the ability of investors to sue companies doing business with the public company in which they invested – i.e., customers or suppliers – for securities fraud. While they may still be subject to criminal penalties or civil enforcement action by the SEC, these “ordinary businesses” may be sued by investors only if they themselves make deceptive statements or acts that the investors directly relied on, as opposed to simply knowing about or even participating in the public company’s underlying fraudulent scheme.

Stoneridge involved an alleged scheme by a publicly-held cable television company, Charter Communications, to inflate its reported revenues with the alleged assistance of two of its vendors, Scientific-Atlanta and Motorola. According to the plaintiffs, Charter agreed to pay Scientific-Atlanta and Motorola inflated prices for set-top cable boxes in exchange for the vendors agreeing to buy advertising from Charter at far higher rates than usual. The vendors allegedly backdated contracts and falsified other documents to help Charter improperly book the advertising “purchases” as revenue. The price of Charter’s stock ultimately collapsed after a series of fraudulent accounting practices came to light.

The plaintiffs in *Stoneridge* sought to hold Scientific-Atlanta and Motorola liable as participants in Charter’s fraud under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. (Neither vendor had misrepresented its finances to its own shareholders, and neither had made any misrepresentations directly to Charter’s shareholders.) Section 10(b) and Rule 10b-5 make it unlawful to commit a manipulative or deceptive act in connection with the purchase or sale of securities, and for decades courts have recognized an implied private right of action for damages under these provisions.

However, in its 1994 ruling in *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court rejected § 10(b) liability for actors who “aid and abet” fraud. Congress subsequently authorized “aiding and abetting” liability for actions prosecuted by the SEC, but not for private investor lawsuits.

In *Stoneridge*, the investors relied on the theory of “scheme liability,” in which participants in a fraudulent scheme may be held responsible even if they did not make any statements to the investing public. The Court, in a 5-3 ruling, first observed that the investors were correct in arguing that that “deceptive conduct” may be sufficient to establish liability; there does not have to be “a specific oral or written statement,” as the court below had suggested.

The *Stoneridge* investors fell short, however, on another required element for private suits under § 10(b): **reliance** by the investors on the defendants' deceptive statement or act. As the Court summarized, the vendors "had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of [the vendors'] deceptive acts during the relevant times."

The investors argued that there was in fact reliance, since the vendors allegedly knew that their deceptive acts would provide the basis for financial statements released by Charter to the public. The Court disagreed. Noting that nothing that the vendors did "made it necessary or inevitable for Charter to record the transactions it did," it ruled that any reliance by the investors was "too remote for liability" under § 10(b)'s implied private right of action. To allow investors to sue the vendors under § 10(b) under such an attenuated theory of reliance, the Court concluded, would obliterate the distinction between "the securities markets" (governed by § 10(b) and other federal securities law) and "ordinary business operations" (governed mainly by state law) and undermine its earlier ruling in *Central Bank*.

The Supreme Court's ruling in *Stoneridge* provides further evidence of the Court's current distaste for lawyer-driven shareholder litigation. For example, in its 2007 ruling in *Tellabs v. Makor Issues & Rights*, the Court cited "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers" as grounds for setting a high bar for the pleading of scienter. In *Stoneridge*, the Court similarly reasoned that adoption of the investors' theory of liability would expose "the entire marketplace" to the costs of discovery, and that the risk that "plaintiffs with weak claims" would try to "extort settlements" – as well as deter overseas firms from doing business in the U.S. (In dissent, by contrast, Justice Stevens contended that by rendering § 10(b)'s private right of action "toothless," the ruling may weaken "investor faith in the safety and integrity of our markets.")

Clearly, *Stoneridge* provides substantial relief for businesses not directly involved in the securities markets. Even if a claim could be made that such businesses knowingly assisted corporate wrongdoers, they may not be sued by private investors under § 10(b) unless they directly misled investors. More generally, the Court's observation that the reach of § 10(b)'s private right of action should not normally extend to "ordinary business operations" may well signal its attitude toward the resolution of § 10(b) claims in other contexts.

The consequences of *Stoneridge* for other "secondary actors" – such as accounting firms, investment banks, and law firms – are less clear. Because these actors arguably operate in "the investment sphere" (to use the Court's words) and may participate in the drafting or approval of public statements made by corporate issuers, *Stoneridge*'s focus on the reliance element may not directly offer them much help. However, *Stoneridge* continues along the Supreme Court's current trajectory of curtailing private securities actions and redirecting emphasis toward regulatory enforcement.

In conclusion, while *Stoneridge* represents the latest in a series of victories for corporate defendants in the Supreme Court, the win was not as big as some businesses had hoped. Deceptive conduct – sham transactions, rigged prices, etc. – remains actionable, even without explicit oral or written statements. And parties that participate in fraudulent schemes, or otherwise "aid and abet" fraud, may be sued in civil enforcement actions by the SEC or prosecuted criminally by the Justice Department. Furthermore, the Supreme Court's curtailment of the implied right of action may lead Congress to provide additional resources for these agencies to pursue securities fraud – if not amend the underlying law. The scope of liability for securities fraud is likely to remain a hot issue in the years ahead.

Tony Mirenda and Robert Toone are attorneys in Foley Hoag's Business Crimes Group. They represent corporations, officers, directors and other individuals in criminal, regulatory, administrative and civil proceedings. If you would like additional information on this topic, please contact Tony Mirenda at amirenda@foleyhoag.com or Robert Toone at rtoone@foleyhoag.com or contact your attorney at Foley Hoag LLP. For Alerts and Updates on other topics, please visit foleyhoag.com.



BOSTON | WASHINGTON | EMERGING ENTERPRISE CENTER | FOLEYHOAG.COM

This Update is for information purposes only and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult your own lawyer concerning your own situation and any specific legal questions you may have. United States Treasury Regulations require us to disclose the following: Any tax advice included in this Update and its attachments is not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

Copyright © 2008 Foley Hoag LLP.

Attorney Advertising. Prior results do not guarantee a similar outcome.